Krispy kreme: overview

Business, Company

INTRODUCTION

First, I will discuss theenvironmentof Krispy Kreme and my analysis as to what led to the company’s position in 2004. Second, I will discuss the financialhealthand current condition based upon the historical income statements and balance sheets. Third, I will discuss the financial ratios in relation to the financial statements. Fourth, I will discuss if Krispy Kreme was financially healthy at the end of 2004. Fifth, I will discuss my assessment of Krispy Kreme’s health and why I think the stock price dropped by 80% between 2003 and 2004.

Sixth, I will discuss why I think the market reacted so negatively to the disclosures about adverse results and the revelations in the Wall Street Journal regarding the firm’s accounting methods for the franchise rights. Lastly, I will provide my recommendations for turning around Krispy Kreme Doughnuts’ business.

COMPANY POSITION

Krispy Kreme Doughnuts started small by selling directly to grocery stores. Their doughnuts became so popular they began selling directly to customers. They sold a delicious doughnut and a viewing experience.

When Beatrice Foods bought the company, her business model did not succeed because it expanded the product line in the opposite direction of what consumers wanted and she inputted cheap ingredients into a popular recipe which sacrificed taste. When she sold the company to the group of franchisees, it pushed the company back into a positive direction by bringing back the original recipe. Krispy Kreme was debt-free by 1989 and their IPO left them with a market capitalization of nearly $500 million in 2000.

They appeared to be on the right track but, it seemed they were expanding too rapidly. They allowed franchisees to place their stores in locations that were not favorable, resulting in the franchises not doing well enough and owing Krispy Kreme Doughnuts millions. Krispy Kreme relied on the income from franchised stores purchases of equipment and mixes too much. They also had their product in too many locations, creating an increase of supply and a decrease in demand.

HISTORICAL FINANCIAL STATEMENT ANALYSIS

On further analysis of the historical income statement, it seems that Krispy Kreme Doughnuts' operating expenses are increasing gradually every year and are over 75% of total revenues for each year. The only income statement item that has decreased significantly was interest income from 2002 through 2004. Everything else seemed to point towards a profitably company because both gross profit and net income were increasing by at least 2% every year. On further analysis of the historical balance sheet there we some large red flag items.

Property and equipment, net of depreciation was a significant portion of total assets each year. Most of the equipment they created was sold to franchisees and used in each company owned or franchisee owned factory stores. The significant amount on their balance sheet could have meant that they were manufacturing equipment faster than they were selling it to their franchises or due to the fact that they were expecting to expand, but were not able to expand to the extent they wanted to. As a percent of total assets, accounts receivable declined from 17% in 2000 to 7 % in 2004.

Inventories were significantly increasing each year, but one would assume that some of their inventory would have to be written of due to the items expiration date (doughnuts can only last so long, so they appear to not be selling as much). Reacquired franchise rights, goodwill and other intangibles significantly increased starting in 2002, and every year after that. It rose in those years to be close to one third (30%) of total assets, which was the biggest item percentage wise other than property and equipment. The most significant item on the liabilities and shareholders' equity section of the balance sheet is common stock.

Every year common stock was close to 50% of total liabilities and shareholders' equity. In my opinion, Krispy Kreme Doughnuts, recognized they were in trouble with the increasing failures of franchises and kept issuing more stock in hopes to bail themselves out.

FINANCIAL RATIO ANALYSIS

In exhibit seven the time series of the ratios raise one specific question. The inventory turnover raises the question as to why it was taking longer for their inventory to sell. When converted to days, the ratio determined that their inventory took over twenty-three days to turnover in 2003.

It seems that Krispy Kreme Doughnuts' inventory was over saturated in the market. With an abundance in supply, it seems that their doughnuts were not as in demand. When comparing Krispy Kreme Doughnuts' financial ratios to others in the industry, I determined that Krispy Kreme was doing better in some areas than those in the industry such as with their liquidity ratios. Krispy Kreme's liquidity ratios were significantly higher than any company in its industry. In other areas, such as profitability ratios, Krispy Kreme was about average compared to other companies.

Krispy Kreme's activity ratios were significantly lower than any other company in its industry, meaning their assets are not turning over as much as other companies. In such an industry, product seems to move fast, which further supports my notion that their product was becoming less popular due to the saturated market. It seems a lot more companies in this industry support operations with debt rather than capital, Krispy Kreme was doing the opposite. Exhibit nine supports this position because no other company had a significant amount of shareholders' equity like Krispy Kreme.

Other companies were better able to handle their operating expenses keeping them closer to 50% of net sales, unlike Krispy Kreme who kept theirs closer to 75%, but Krispy Kreme also had a higher percent of net sales in relation to operating profit and profit before taxes.

FINANCIALLY HEALTHY AT YEAR END

2004? In my opinion, Krispy Kreme Doughnuts is not completely healthy at the financial year end of 2004. Their income statement shows an increased net income from the year before, butI believethat increase can only last so long.

With the inability to expand further, and current operations decreasing more than they are making, I do not expect their net income to increase by year end 2005. Everything on their balance sheet is increasing, including their inventory. They need to realize that they are simply not selling product. Although their debt is low, that is from the increasing stockholders' equity in the form of stocks. With the outlook of the company not good, they cannot expect to support their operations with the issuance of new stock. They need to find a new way tofinancetheir operations and ecrease their operating costs.

STOCK PRICE DECREASE AND NEGATIVE MARKET REACTION

In my opinion investors recognized the same warning signs that I did when analyzing Krispy Kreme Doughnuts' financial statements and decided to drop their losses while they could still make some kind of profit selling off the stock. When Krispy Kreme announced to investors to expect earnings to be " 10% lower than anticipated, claiming that the recent low-carbohydrate diet trend in the US had hurt wholesale and retail sales," I think they further expected that something was not right with the picture they were portraying.

The Wall Street Journal article, revealed an accounting practice that was not commonly followed by others in Krispy Kreme's industry. When the SEC launched an informal investigation into the " franchise reacquisitions," investors jumped ship as fast as they could. The significant decrease in stock from 2003 to 2004, was investors getting nervous and protecting themselves from their stock being worth near nothing.

RECOMMENDATIONS

In my opinion Krispy Kreme Doughnuts needs to make radical changes to the way it conducts business.

I think they should completely stop off-premise sales, making their product only available in factory stores. This would hopefully decrease their inventory and decrease operating expenses related to the fleet of trucks that deliver product to grocery stores. Selling their product in factory stores only will hopefully recreate the demand for the doughnuts that there once was. I also believe that they should decrease the amount of franchises and refocus to company owned stores.

Franchisees might not properly know how to pick a location or be properly trained, as seen with the increase of failing franchises. This would decrease the large amount on their balance sheet from reacquiring franchises. Focusing their business to one or two types of primary sources of income and reducing expenses would be a way to help lower market saturation of their product. Having more company owned factory stores, provides Krispy Kreme a chance to have more control over their operations and not depend on franchisees to make a profit for them.